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before the
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Chairman Dodd, Ranking Member Shelby, thank you for the opportunity to testify before your committee today about financial reform – and in particular about the Administration's recent proposals to prohibit certain risky financial activities at banks and bank holding companies and to prevent excessive concentration in the financial sector.

The recent proposals complement the much broader set of reforms proposed by the Administration in June, passed by the House in December, and currently under consideration by this committee. We have worked closely with you and with your staffs over the past year, and we look forward to working with you to incorporate these additional proposals into comprehensive legislation.

Sixteen months from the height of the worst financial crisis in generations, no one should doubt the urgent need for financial reform. Our regulatory system is outdated and ineffective, and the weaknesses that contributed to the crisis still persist. Through a series of extraordinary actions over the last year and a half, we have made significant progress in stabilizing the financial system and putting our economy back on the path to growth. But the progress of recovery does not diminish the urgency of the task at hand. Indeed, our financial system will not be truly stable, and our recovery will not be complete, until we establish clear new rules of the road for the financial sector.

The goals of financial reform are simple: to make the markets for consumers and investors fair and efficient; to lay the foundation for a safer, more stable financial system, less prone to panic and crisis; to safeguard American taxpayers from bearing risks that ought to be borne by shareholders and creditors; and to end, once and for all, the dangerous perception any financial institution is "Too Big to Fail."

The ingredients of financial reform are clear:

All large and interconnected financial firms, regardless of their legal form, must be subject to strong, consolidated supervision at the federal level. The idea that investment banks like Bear Stearns or Lehman Brothers or other major financial firms could escape consolidated federal supervision should be considered unthinkable from now on.

The days when being large and substantially interconnected could be cost-free – let alone carry implicit subsidies – should be over. The largest, most interconnected firms should face significantly higher capital and liquidity requirements. Those requirements should be set at levels that compel the major financial firms to pay for the additional costs that they impose on the financial system, and give such firms positive incentives to reduce their size, risk profile, and interconnectedness.

The core infrastructure of the financial markets must be strengthened. Critical payment, clearing, and settlement systems, as well as the derivatives and securitization markets, must be subject to thorough, consistent regulation to improve transparency, and to reduce bilateral counterparty credit risk among our major financial firms. We should never again face a situation – so devastating in the case of AIG – where a virtually unregulated major player can impose risks on the entire system.

The government must have robust authority to unwind a failing major financial firm in an orderly manner – imposing losses on shareholders, managers, and creditors, but protecting the broader system and ensuring that taxpayers are not forced to pay the bill.

The government must have appropriately constrained tools to provide liquidity to healthy parts of the financial sector in a crisis, in order to make the system safe for failure.

And we must have a strong, accountable consumer financial protection agency to set and enforce clear rules of the road for providers of financial services – to ensure that customers have the information they need to make fully informed financial decisions.

Throughout the financial reform process, the Administration has worked with Congress on reforms that will provide positive incentives for firms to shrink and to reduce their risk and to give regulators greater authorities to force such outcomes. The Administration's White Paper, released last June, emphasized the need to give regulators extensive authority to limit risky, destabilizing activities by financial firms. We worked closely with Chairman Frank and subcommittee Chairman Kanjorski in the House Financial Services Committee to give regulators explicit authority to require a firm to cease activities or divest businesses that could threaten the safety of the firm or the stability of the financial system.

In addition, through tougher supervision, higher capital and liquidity requirements, the requirement that large firms develop and maintain rapid resolution plans – also known as "living wills" – and the financial recovery fee which the President proposed at the beginning of January, we have sought indirectly to constrain the growth of large, complex financial firms.

As we have continued our ongoing dialogue, within the Administration and with outside advisors such as the Chairman of the President's Economic Recovery Advisory Board, former Federal Reserve Chairman Paul Volcker, whose counsel has been of tremendous value, we have come to the conclusion that further steps are needed: that rather than merely authorize regulators to take action, we should impose mandatory limits on proprietary trading by banks and bank holding companies, and related restrictions on owning or sponsoring hedge funds or private equity funds, as well as on the concentration of liabilities in the financial system. These two additional reforms represent a natural – and important – extension of the reforms already proposed.

Commercial banks enjoy a federal government safety net in the form of access to federal deposit insurance, the Federal Reserve discount window, and Federal Reserve payment systems. These protections, in place for generations, are justified by the critical role the banking system plays in serving the credit, payment and investment needs of consumers and businesses.

To prevent the expansion of that safety net and to protect taxpayers from risk of loss, commercial banking firms have long been subject to statutory activity restrictions, and they remain subject to a comprehensive set of activity restrictions today. Activity restrictions are a hallowed part of this country's bank regulatory tradition, and our new scope proposals represent a natural evolution in this framework.

The activities targeted by our proposal tend to be volatile and high risk. Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms "bailed out" their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most. The complexity of owning such entities has also made it more difficult for the market, investors, and regulators to understand risks in major financial firms, and for their managers to mitigate such risks. Exposing the taxpayer to potential risks from these activities is ill-advised.

Moreover, proprietary trading, by definition, is not done for the benefit of customers or clients. Rather, it is conducted solely for the benefit of the bank itself. It is therefore difficult to justify an arrangement in which the federal safety net redounds to the benefit of such activities.

For all these reasons, we have concluded that proprietary trading, and the ownership or sponsorship or hedge funds and private equity funds, should be separated, to the fullest extent practicable, from the business of banking – and from the safety net that benefits the business of banking.

While some details concerning the implementation of these proposals will appropriately be worked out through the regulatory process following enactment, it may be helpful if I take a moment to clarify the Administration's intentions on a few particularly salient issues.

First, with respect to the application of the proposed scope limits: all banking firms would be covered. This means any FDIC-insured depository institution, as well as any firm that controls an FDIC-insured depository institution. In addition, the proposal would apply to the U.S. operations of foreign banking organizations that have a U.S. branch or agency and are therefore treated under current U.S. law as bank holding companies. The prohibition also would generally apply to the foreign operations of U.S.-based banking firms.

This proposal forces firms to choose between owning an insured depository institution and engaging in proprietary trading, hedge fund, or private equity activities. But – and this is very important to emphasize – it does not allow any major firm to escape strict government oversight. Under our regulatory reform proposals, all major financial firms, whether or not they own a depository institution, must be subject to robust consolidated supervision and regulation – including strong capital and liquidity requirements – by a fully accountable and fully empowered federal regulator.

Second, with respect to the types of activity that will be prohibited: this proposal will prohibit investments of a banking firm's capital in trading operations that are unrelated to client business. For instance, a firm will not be allowed to establish or maintain a separate trading desk, capitalized with the firm's own resources, and organized to speculate on the price of oil and gas or equity securities. Nor will a firm be allowed to evade this restriction by simply rolling such a separate proprietary trading desk into the firm's general market making operations.

The proposal would not disrupt the core functions and activities of a banking firm: banking firms will be allowed to lend, to make markets for customers in financial assets, to provide financial advice to clients, and to conduct traditional asset management businesses, other than ownership or sponsorship of hedge funds and private equity funds. They will be allowed to hedge risks in connection with client-driven transactions. They will be allowed to establish and manage portfolios of short-term, high-quality assets to meet their liquidity risk management needs. Traditional merger and acquisition advisory, strategic advisory, and securities underwriting, and brokerage businesses will not be affected.

In sum, the proposed limitations are not meant to disrupt a banking firm's ability to serve its clients and customers effectively. They are meant, instead, to prevent a banking firm from putting its clients, customers and the taxpayers at risk by conducting risky activities solely for its own enrichment.

Let me now turn to the second of the President's recent proposals: the limit on the relative size of the largest financial firms.

Since 1994, the United States has had a 10% concentration limit on bank deposits. The cap was designed to constrain future concentration in banking. Under this concentration limit, firms generally cannot engage in certain inter-state banking acquisitions if the acquisition would put them over the deposit cap.

This deposit cap has helped constrain the growth in concentration among U.S. banking firms over the intervening years, and it has served the country well. But its narrow focus on deposit liabilities has limited its usefulness. Today, the largest U.S. financial firms generally fund themselves at significant scale with non-deposit liabilities. Moreover, the constraint on deposits has provided the largest U.S. financial firms with a perverse incentive to fund themselves through more volatile forms of wholesale funding.
Given the increasing reliance on non-bank financial intermediaries and non-deposit funding sources in the U.S. financial system, it is important to supplement the deposit cap with a broader restriction on the size of the largest firms in the financial sector.

This new financial sector size limit should not require existing firms to divest operations. But it should serve as a constraint on future excessive consolidation among our major financial firms.

The size limit should not impede the organic growth of financial firms – after all, we do not want to limit the growth of successful businesses. But it should constrain the capacity of our very largest financial firms to grow by acquisition.

The new limit should supplement, not replace, the existing deposit cap. And it should at a minimum cover all firms that control one or more insured depository institutions, as well as all other major financial firms that are so large and interconnected that they will be brought into the system of consolidated, comprehensive supervision contemplated by our reforms.

An updated size limit for financial firms will have a beneficial effect on the overall health of the financial system. Limiting the relative size of any single financial firm will reduce the adverse effects from the failure of any single firm.
These proposals should strengthen our financial system's resiliency. It is true today that the financial systems of most other G7 countries are far more concentrated than ours. It is also true today that major financial firms in many other economies generally operate with fewer restrictions on their activities than do U.S. banking firms. These are strengths of our economy – strengths that we intend to preserve.

Limits on the scale and scope of U.S. banking firms have not materially impaired the capacity of U.S. firms to compete in global financial markets against larger, foreign universal banks, nor have these variations stopped the United States from being the leading financial market in the world. The proposals I have discussed today preserve the core business of banking and serving clients, and preserve the ability of even our largest firms to grow organically. Therefore we are confident that we should not impact the competitiveness of our financial firms and our financial system.

Before closing, I would like to again emphasize the importance of putting these new proposals in the broader context of financial reform. The proposals outlined above do not represent an "alternative" approach to reform. Rather, they are meant to supplement and complement the set of comprehensive reforms put forward by the Administration last summer and passed by the House of Representatives before the holidays.

Added to the core elements of effective financial reform previously proposed, the activity restrictions and concentration cap that are the focus of today's hearing will play an important role in making the system safer and more stable. But like each of the other core elements of financial reform, the scale and scope proposals are not designed to stand alone.

Members of this committee have the opportunity – by passing a comprehensive financial reform bill – to help build a safer, more stable financial system. It is an opportunity that may not come again. We look forward to working with you to bring financial reform across the finish line – and to do all that we can to ensure that the American people are never again forced to suffer the consequences of a preventable financial catastrophe.

Thank you.